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September 25, 1970

Professor Stephen A. Zeff
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Dear Steve:

As you requested, I am enclosing a copy of the paper I presented at the Conference in Edinburgh.

Sincerely yours,

George

George R. Catlett

THE ROLE OF THE ACCOUNTING PROFESSION IN ESTABLISHING PRINCIPLES

by

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The accounting profession in the United States has been engaged in a tremendous effort to establish appropriate accounting principles for business enterprises. The total annual cost of this program, much of which is contributed time, is probably about two million dollars. Serious questions have been raised from various sources as to whether the results are worth the effort and whether the program is sufficiently effective and timely to accomplish what needs to be done. The answers to such questions are clear: (1) The accounting profession must have such a program; and (2) significant improvements in the program are essential if the necessary goals are to be attained.

As a member of the Accounting Principles Board (APB) and as chairman of my firm's policy committee on accounting principles, I have had an opportunity to observe the efforts to achieve progress in recent years. In this connection, we should consider what needs to be done, including the obstacles which must be overcome, in the development and application of sound accounting principles. The difficulties involved are somewhat similar in many countries, even though the laws and customs are different. Hopefully, we can all learn by exchanging comments as to our experiences.

Research

Adequate research is essential to achieving proper solutions to our accounting problems. The American Institute of

Certified Public Accountants has published eleven research studies and several others are in process. The general quality of these studies has been quite good. The average time required to complete the studies has probably been about four or five years, with some taking longer. Since the need for a solution to many of these problems has been urgent, the delays in the completion of the studies have been a handicap. However, such delays have not been crucial in the work of the APB because of the huge backlog of work which has been on the agenda of the APB since it was established in 1959.

In addition to the formal studies, the American Institute staff and several accounting firms have done a wide variety of research of lesser magnitude. Also, the results of research done by other organizations, such as the Financial Executives Institute and the National Association of Accountants, have been made available.

While research is obviously necessary, there is a tendency at times to overemphasize its importance. Some accountants have the belief that a sufficient quantity of the right kind of research will solve most of our problems and overcome resistance to change by the sheer force of its volume and persuasiveness. However, such a conclusion is unwarranted in an area such as accounting where practical effects are so pervasive and where the objectives are so undefined.

Research will never replace the need for the application of judgment and experience by a group of highly qualified and knowledgeable persons. The problems which exist in present-day business activities are so complex that unusual ingenuity and resourcefulness are necessary in dealing with them. The final authoritative decisions as to the best accounting and reporting must be based on many factors, such as those involved in determining what represents the fairest presentation of the facts to the various segments of our society -- shareholders, potential investors, creditors, employees, customers, and management. Accounting must have a sound and logical theory base, but the principles followed must be those which produce the most useful results in everyday life.

Many questions have been raised as to the type of research which is best. At the present time, only two of the eleven published research studies have been used effectively by the APB, even though pronouncements have been issued on several of the subjects. This lack of effective usage could be the fault of the APB as much as or more than that of the researchers. In the case of several APB Opinions, the conclusions drawn were probably the same as they would have been without any formal research study. The profession needs to give further consideration to ways and means of obtaining research which is of maximum usefulness and of improving the manner in which the research is used by the APB.

One of the questions frequently asked is -- why have accountants in the academic field not made more of a contribution to research which would be of benefit to the accounting profession in solving its problems? With all due respect to Dr. Maurice Moonitz, who is a participant in this program and has made significant contributions to the accounting profession, the research by academicians as a group has not been as effective as it should have been and has not been as productive as in several other fields of learning. Efforts should be made by all concerned to correct this situation, because all available resources should be made available to, and used by, the profession.

In brief, research is important, but it is only the beginning of the task to be accomplished, and it is not the end by any means.

Responsibilities of Various Parties Involved with the Issuance of Financial Statements

One of the most difficult phases of the task of improving accounting principles relates to the responsibilities of the various parties involved with the issuance of financial statements. My comments in this regard should be considered in the light of the fact that many legal actions are being filed in courts in the United States against managements and independent auditors for damages incurred because of reliance on alleged

misleading financial statements. This trend has accelerated as a result of the sharp drop in the stock market over the last year and an increase in bankruptcies and other financial difficulties. When money is lost, investors and creditors have an incentive to try to blame their losses on someone with financial resources.

Managements. There seems to be general agreement that the primary responsibility for the preparation and content of financial statements rests with the management of the issuing company. Yet, the accounting profession, governmental agencies, and stock exchanges are prescribing accounting and reporting rules which must be followed by managements. The alternative to not following such rules involves all sorts of dire consequences to the managements and their companies. Auditors threaten to qualify their reports. Governmental agencies have strong retaliatory powers. Stock exchanges have the right to remove securities from trading. What are the rights and responsibilities of managements when they honestly believe that rules imposed upon them do not result in the best presentation of the facts but rather produce misleading results? Do managements have adequate defenses if they are required to follow accounting principles with which they do not agree, and if they are subsequently attacked in court?

Independent auditors. The responsibility of independent auditors runs not only to their clients but also to third parties who rely on the financial statements upon which

the auditors report. This third-party responsibility is unique among the professions, and the legal consequences of this responsibility may vary among different countries depending upon the laws and court decisions. Auditors in the United States have a significant potential legal liability to third parties, and their responsibility is being expanded by the courts. The reliance by third parties on the reporting of Certified Public Accountants on financial statements is one of the principal reasons why CPAs are licensed and regulated by the states.

Both under the Securities Act of 1933 and under common law, auditors issuing reports have a responsibility to base those reports on their own view of what represents a fair presentation of the facts. This responsibility cannot be avoided merely by blaming a host of other people. An opinion written in 1947 by a lawyer who was quite knowledgeable as to the provisions of the Securities Act of 1933 stated as follows:

> "While the form and content of the financial statements are subject to the rules and regulations of the Securities and Exchange Commission the opinions expressed in the certificate by the accountant are his alone and he is the person who will be held responsible therefor. The accountant is also responsible for the examination and review of those financial statements,

used in the registration statement, as to which he undertakes to express his expert opinion, and his responsibility relates not only to the propriety of what is set forth in the financial statements, but also to the inclusion of such additional information as is necessary to make such statements not misleading."

What are the responsibilities of an auditor when he honestly believes that following a pronouncement of the APB or a regulation of the Securities and Exchange Commission (SEC) does not result in a fair presentation of the facts? Neither the APB nor a governmental agency has any specific responsibility, legally or otherwise, for the contents of a particular set of financial statements. This responsibility rests primarily with the management but the auditors also share in this responsibility. What position are the auditors in if they are forced, directly or indirectly, by professional organizations or governmental agencies to give an unqualified report on financial statements which they do not, in fact, believe are proper?

Governmental agencies. In addition to the SEC which was established to protect investors, numerous Federal and state regulatory agencies in the United States have statutory powers to regulate particular industries, such as public utilities, transportation and communication companies, banks, savings and loan associations, and insurance companies. The rules

and regulations of these agencies may or may not conform to what the accounting profession would consider to be "generally accepted accounting principles."

While the accounting profession has taken the position that rules published by a governmental agency with control over an industry do not necessarily establish generally accepted accounting principles for that industry, such rules frequently have the effect of law. While auditors can, and do, qualify their reports when companies follow the required accounting which does not meet the standards of the accounting profession, this situation is not desirable from the standpoint of the public, and efforts are being made to eliminate such differences.

In general, the SEC and the accounting profession have cooperated well enough to avoid significant differences in the accounting principles and practices followed by them. A similar level of cooperation has not yet been achieved between the accounting profession and the other Federal and state regulatory agencies.

Stock exchanges. The stock exchanges have certain requirements for listing purposes, and occasionally have prescribed accounting rules. The exchanges have usually followed the lead of the accounting profession and the SEC. As a result, conflicts in policy between the profession and the stock exchanges have been rare.

Professional associations. Two types of pronouncements could be issued by a professional committee such as the APB: (1) Recommendations which are based only upon subsequent acceptance and do not have to be followed by members of the association, and (2) requirements which must be followed by members of the association in reporting on financial statements. A professional association cannot set forth absolute requirements for anyone but its members, unless there are laws giving the association, directly or indirectly, authority to do so. There are no such laws in the United States.

The Council of the American Institute (the governing body representing the members) stated by formal resolution in 1964 that its members should follow APB Opinions, as representing "generally accepted accounting principles," and there is to be no departure from such Opinions unless "substantial authoritative support" can be found for another approach. Departures from positions established in APB Opinions must then be disclosed in the auditor's report or in the footnotes to the financial statements. The burden of proof is placed upon the auditor who departs from the APB Opinion to support the alternative used. A recent attempt to incorporate this requirement in the code of professional ethics barely failed to obtain the necessary affirmative vote. Thus, the support of the APB Opinions is dependent upon the voluntary cooperation of the accounting firms and the members of the Institute. This support has been almost complete during the last six years, but there is no assurance that such support will continue indefinitely.

I know of no case in which any member of the American Institute has relied upon "substantial authoritative support" to defend a direct and significant departure from an APB Opinion. Auditors have been qualifying their reports for such departures. However, the alternative of relying on "substantial authoritative support" is always available and is a potential weakness in establishing effective standards. This alternative was established by the Council as a compromise when there was a heated controversy in 1964 as to whether American Institute members should be required to follow APB Opinions as representing the only acceptable accounting principles.

Only confusion results when "generally accepted accounting principles" are described officially as those principles which have "substantial authoritative support." An undefined term is used to define another undefined term. No one really knows what "general acceptance" means -- by whom and to what extent. At one time, the accounting bulletins issued by the American Institute were based on subsequent "general acceptance" but the APB Opinions are now considered to be authoritative when issued; and acceptance by the profession is assumed whether the members of the American Institute approve of the conclusions or not. The members have delegated to the APB final authority, without review by any other group, to issue pronouncements on accounting principles. An APB subcommittee appointed to define or describe "substantial authoritative support" finally gave up in frustration after struggling with the problem for some time.

Relationship of responsibilities. The interrelationship of the various parties involved with the issuance of financial statements can be summarized briefly. A committee in a professional association can bind only the action of its members, and this may be done either by threat of expulsion from membership or by voluntary cooperation. The latter course is satisfactory as long as everyone sticks together, but such cooperation is tenuous and subject to breakdown at any time. In fact, if one major accounting firm refused to follow an APB Opinion, the whole structure might fall apart.

Managements cannot be required by auditors to follow the pronouncements of professional committees, but the auditors, as members of the professional association, can use the threat of qualification of their reports as a weapon. A governmental agency, such as the SEC, can refuse to accept a qualified auditor's report and can require companies subject to its jurisdiction to follow the professional pronouncements. Some managements are claiming that the SEC is using the APB as an unofficial regulatory arm, and is enforcing APB Opinions as though they were SEC regulations, but without going through the rule-making procedures for a governmental agency as required by law.

While managements have a responsibility of their own, they have other organizations and agencies telling them what they must do. Yet, those organizations and agencies do not

assume any direct responsibility for the company's financial statements.

The APB and the SEC obviously should work together. However, the APB needs the cooperation and support of the SEC, not its domination. While the SEC has generally supported the APB, and the SEC has frequently acknowledged its reliance on the accounting profession, there is no requirement to do so. The SEC has extensive statutory powers to prescribe accounting principles and practices to any extent it chooses. Also, the regulatory function of the SEC under the laws should not be mixed up and confused with the professional function of the APB in establishing accounting principles.

With respect to auditors, it is unlikely that the courts will permit the self-established standards of the accounting profession to be a successful defense for a member of that profession unless the results in the particular case represent a fair presentation of the facts and are not misleading in any significant respect. The courts are likely to hold to a standard of fairness in financial reporting which will not necessarily be limited to "fair presentation in conformity with generally accepted accounting principles."

Thus, the foundation of existing relationships is on somewhat shaky ground with respect to who is really

responsible for what. Perhaps only the legislative bodies and the courts, which represent the public broadly, can make the final determinations.

Obstacles to Progress

The APB has been involved in some very controversial and bitter debates in recent years. The most recent one, which has just been completed, relates to the accounting for business combinations and for intangible assets, including purchased goodwill. The wounds from this battle are still open, and the ultimate repercussions are as yet unknown.

The eighteen members of the APB are as sincere and hardworking a group of men as I have ever known in connection with a volunteer professional committee. The time and effort expended have been far more than most people can imagine and more than anyone has a right to expect. The APB has been meeting for three or four days about every six weeks. More than 25 subcommittees are in operation. Each member of the APB is on several of these subcommittees, and these meet frequently. One subcommittee, of which I was a member, met about twenty times within a year. Vast quantities of all kinds of information, including numerous drafts and letters, are sent constantly to all APB members. Each member was furnished with copies of the 860 letters received from the last exposure draft of an Opinion submitted for public comment. Any deficiencies

in this program cannot be traced to a lack of effort. Yet, lessons are to be learned and obstacles are to be overcome.

The pressures against change, when the changes are on a mandatory basis and are significant in effect, are very strong. These pressures are a natural result of a quasi-legislative process in a democratic society. Such pressures are not to be deplored but should be dealt with for what they are, as a part of our system. It is naive, however, to assume that the various viewpoints vigorously expressed in a variety of ways do not have an effect on the total process. These pressures come from within the profession as well as from outside.

A quasi-legislative body, such as the APB, can reach agreement only by compromise. With eighteen members and a two-thirds vote requirement, solutions to highly controversial subjects are almost certain to end up in compromise. While rules and regulations can be arrived at by compromise, this process strains the logic and reasoning which are so necessary in establishing a reasonable set of accounting principles. One proposed principle in a particular area may be as logical as an alternative principle, but half way in between is no principle at all. Such compromises are very vulnerable to attack, and subsequent deterioration in practice is likely.

A form of compromise is the temptation, when dealing with difficult problems, to "patch up" the situation rather than to be more decisive and constructive. This approach ends up

with patches which do not stick. The result usually is a deterioration in practice which ultimately requires another and delayed effort to achieve the improvement which was needed in the first place.

There is a tendency on the part of the APB to want to stop alleged "abuses" in practice and to restrict certain business activities which are perfectly legal and appropriate. Such an attitude is viewed by some persons as an attempt to regulate business. The APB and the profession are on questionable ground to the extent that the pronouncements are of this type. The APB should deal with accounting principles and the accounting for transactions as they occur and not try to influence the occurrence of the transactions. With the APB dominated by auditors, there is an unconscious inclination to adopt the viewpoint of auditors. Those practices which might create auditing problems tend to be deferred or avoided. Such a bias is not necessarily in the best interests of the public.

One of the most frustrating aspects of my service on the APB is the constant presence of a formidable road block. This barrier, which frequently prevents the right kind of progress, is the argument that one change in current practice cannot be made unless many other related changes are also made. Since many changes cannot be made at once, then it follows from this argument that no change, or little change, should be made. As an illustration, the APB is considering whether investments

in marketable securities should be carried at quoted market prices rather than at cost. The predictable opposition states that such a change cannot be made until other assets are also carried at current or fair value.

The solutions to our problems cannot successfully be arrived at on an isolated and uncoordinated basis. When a group of individuals, such as the members of the APB, try to deal with a controversial problem, the determination of a solution is made much more difficult when each member formulates his reasoning from his own concepts ~~and base points.~~ The solution would be difficult enough to agree upon if there were some agreement as to certain concepts and base points. In the absence of such agreement, the various views on concepts and base points get all mixed up and confused with solutions to particular problems.

As an example, how can anyone decide whether lessors should reflect lease rights and obligations in their balance sheets until some decisions are made as to the basic concepts affecting a balance sheet and its contents in general, and the nature of assets and liabilities. The purposes and objectives of financial statements should be established, and then agreement should be reached on certain basic concepts and principles which will accomplish those purposes and objectives. Otherwise, nothing but a group of unrelated rules exist, not supported by

any logical framework of theory and not based on any defensible reasoning. Until these objectives can be established on an authoritative and sound basis, controversy and disorder will prevail. Such an approach is the only way to overcome the previously mentioned argument that piecemeal changes should not be made. If the pieces all fit into an overall plan, it is easier to demonstrate that each of the pieces is an organized step in an evolutionary development which will all fit together when completed.

As I have asked many times -- can we decide how to do something before we decide what it is that we are trying to do?

The APB has made an effort to improve its relationship with organizations representing business enterprises, including several industry associations, as well as organizations representing bankers, lawyers, financial analysts, and other groups. While these organizations tend to represent what might be considered to be the biased viewpoints of their members, improved cooperation would result in a better understanding of the problems involved by everyone concerned and a better acceptance of the solutions when they are determined. Dealing with a large number of these organizations represents some practical difficulties. However, such cooperation is essential to the long-range success of the program.

The Future

In the United States, about thirty million persons own shares, directly or indirectly, in publicly held companies. The uses to which financial statements are being put are expanding in all directions in a dramatic manner. The needs of all of these users of financial statements can be met if the necessary goals are attained by the accounting profession. The profession can and should play a decisive part in establishing sound principles and in improving financial reporting.

The problems and obstacles, which I have reviewed briefly, must be overcome if the accounting profession is to carry out the role which our society has given to it. The profession must take the lead, but the cooperation and assistance of managements, governmental agencies and other interested parties are needed. Ways and means must be found to achieve what is necessary for the common good.

The work of professional committees, such as the APB, involves the public interest in such a significant way that their work must be conducted more like a public body than a private group deliberating in secret. Public hearings and more responsiveness to the views and needs of the public are necessary. Exposure processes must be improved, while at the same time the final decision must be based fairly on all pertinent facts and without any improper influence.

The future of the accounting profession is unlimited, if we only have the courage, ability, resourcefulness and independence to deal with our problems in an effective and constructive manner. Our success will be judged by only one test -- do the accomplishments meet the needs of the public and do the results best serve the public?

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